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Research:

Honolulu City And County, Hawaii; Appropriation, General Obligation Equivalent Security; Tax Secured, General Obligation

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Credit Profile

US$147.66 mil GO bnds ser 2005 F due 07/01/2030	AA-
Sale date: 01-NOV-2005	
US$244.63 mil GO bnds due 07/01/2024	AA-
Sale date: 01-NOV-2005	
AFFIRMED	
$410.527 mil. Honolulu City & Cnty GO	AA-
$275.460 mil. Honolulu City & Cnty GO (FGIC)	AAA/AA-(SPUR)
$26.290 mil. Honolulu City & Cnty GO (FSA)	AAA/AA-(SPUR)
$470.900 mil. Honolulu City & Cnty GO (MBIA)	AAA/AA-(SPUR)
$91.255 mil. Honolulu City & Cnty go unltd tax imp rfdg bonds ser 2004A (MBIA)	AAA/AA-(SPUR)
$192.850 mil. Honolulu City & Cnty go unltd tax imp rfdg bonds ser 2004B (MBIA)	AAA/AA-(SPUR)
OUTLOOK:	POSITIVE

Rationale

Standard & Poor's Ratings Services assigned its 'AA-' rating to Honolulu, Hawaii's series 2005E and 2005F GO refunding bonds and affirmed its 'AA-' rating on the city's outstanding GO debt.

The rating reflects:

- The city's role as the service, trade, and government center for the state of Hawaii;
- A strong tourism sector, with improving tourism statistics after some declines just after Sept. 11, 2001;
- Very strong increases in property values since fiscal 2001;
- Adequate financial performance, including a healthy surplus (unaudited) in fiscal 2005, despite steady declines in property values during much of the mid- to late-1990s; and
- A manageable debt burden with no additional debt plans until fiscal 2007.

Although Standard & Poor's expects that current increases in property values may be more sustainable than in previous cycles, a history of volatility prior to the current rebound continues to be a tempering factor. Demonstration of institutionalized financial reserve policies to formally control and anticipate the potential for revenue volatility may provide additional credit stability and lead to upward rating action.

The bonds are secured by the full faith, credit and unlimited ad valorem taxing authority of the City and County of Honolulu, and are being issued to refinance outstanding debt.

With 876,230 residents, or 72% of the state's total population, Honolulu is Hawaii's economic center and the center of government, transportation, finance, and education. Tourism accounts for about 25% of the gross state product, and Honolulu accounts for more than 50% of the state's hotel rooms. Waikiki, located on Oahu, remains the state's most visited destination. Honolulu's tourism market has rebounded strongly along with the rest of the state. The city and island are additionally anchored by the presence of the U.S. military; there are 33,799 active service men and women on the island, and nearly 15% of the total island population is either employed by or a direct dependent of one of the four branches of the armed services. Unemployment has been steadily declining and is currently at 3%, below the state level and one of the lowest rates for a U.S. city with a population above 750,000. Effective buying income levels are above the state but average overall, at 105% and 90% of the nation on a household and per capita basis, respectively.

The recent economic rebound on Oahu has been led by a strong real estate market, driven by strong appreciation in property values and new construction after an extended period of weakness during the mid- and late-1990s. Since 2001, total assessed value (AV) has increased a very strong 58%, to $114.1 billion in 2006, a high $130,000 per capita. Single-family homes and condominiums account for 56% of this valuation, followed apartments (22%), commercial (10%), industrial (5%), and hotel and resort properties (only 5%). Historic volatility prior to the recent strong recovery was due primarily to concentration of Japanese capital in the real estate market, which is now diminished, though tourism and second-home investment remain primary drivers for economic growth.

Financial performance has been strengthening with improvements in fund balances after a period of revenue contraction prior to fiscal 2001. At the end of fiscal 2004, the city reported a total general fund balance of $62.3 million, or 8.5% of expenditures after transfers, with $41.5 million, or 5.7% of expenditures, unreserved. For fiscal 2005 (unaudited), staff anticipates a healthy $14.8 million general fund surplus, boosting the unreserved fund balance to $57.4 million (7.9% of expenditures), not including an additional $5.0 million reserve set-aside outside the general fund. The current and recent fund balance position is adequate, given historical revenue volatility and the need to reduce services historically without significantly increasing property tax rates. The new mayoral administration has stated its intent to tighten fund balance policies and other financial controls to provide additional stability during periods of potential economic or financial contraction, due to a potentially volatile tourism base. The unaudited 2005 fiscal year was the new administration's first year of financial results and represented a significant improvement over the original budget as well as May 2005 projections (which anticipated balanced performance) due to the administration's focus on expenditure control. In addition, financial staff has implemented monthly budgetary reviews with department staff to track expenditures to budget and generally tighten city budgetary practices, so that budgeted expenditures map more directly to actual costs at year-end. In practice, many departments had regularly delivered sizable positive expenditure variances, reducing budgeted-but-not-realized general fund deficits. Continued attention to such financial controls should provide increased transparency into and tighter control over budgets and reserves.

The city's debt burden is moderate, at $1,810 per capita and 2.0% of AV, excluding self-supported GO debt. The current issuance will refund existing obligations, and the anticipated ongoing capital plan is manageable. Annual general fund-related capital expenditures over the past two years have been $134 million and $147 million, respectively, lower than in prior years. In practice, the city's capital plan has been between 4% and 20% cash-funded, and annual debt service carrying costs have been relatively high, at approximately 19% of total general fund expenditures. The city does not anticipate additional GO debt issuance until 2007.

Outlook

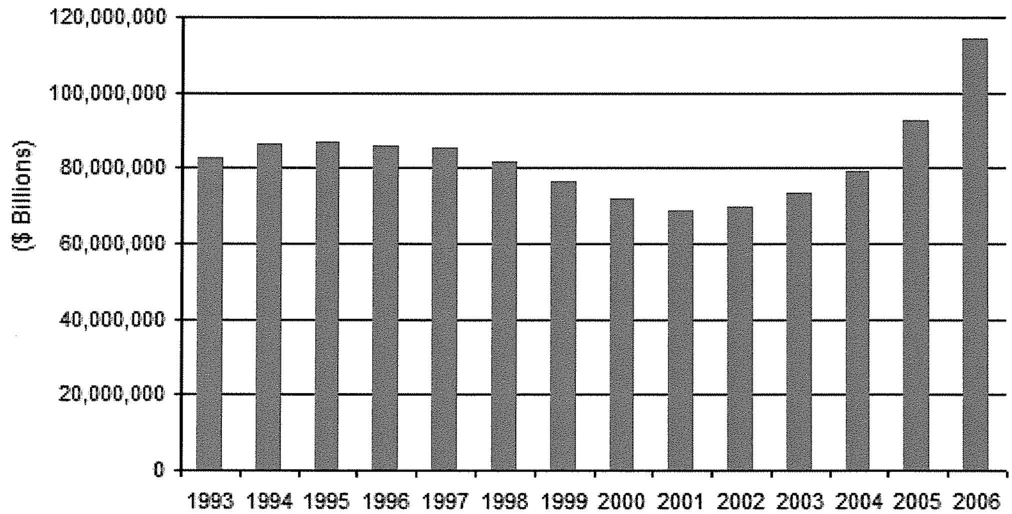
The positive outlook reflects Standard & Poor's expectation that the current administration will continue to implement formalized, conservative financial controls and reserve targets, in order to provide stability in case of future revenue volatility, given some continued reliance on tourism and rapid increases in property values. Currently, staff has begun the formalization of such policies and is in discussion with city council about how best to handle, and control, future expenditure of existing fund balances beyond a $5 million 'rainy day' reserve. Should institutionalization of these policies be extended in future budgets and end-of-year performance, upward rating action may be warranted.

Economy

From 1995 to 2001, property values dropped 23%, due primarily to the aftermath of a boom in construction and property values in the late 1980s driven by Japanese investment. After the departure of this capital, beginning in 1990, the property market weakened significantly. While the tax base has demonstrated this historic volatility, the rating and outlook reflect Standard & Poor's expectation that the current expansion is more sustainable than the one experienced during the late 1980s, due to a more stable source of investment, strong demand characteristics, and more limited housing supply. Since 2001, total AV has increased 35% to $92.4 billion in 2005 and increased an additional 23% in 2006 to $114 billion.

Chart 1

City and County of Honolulu, HI
Assessed Value

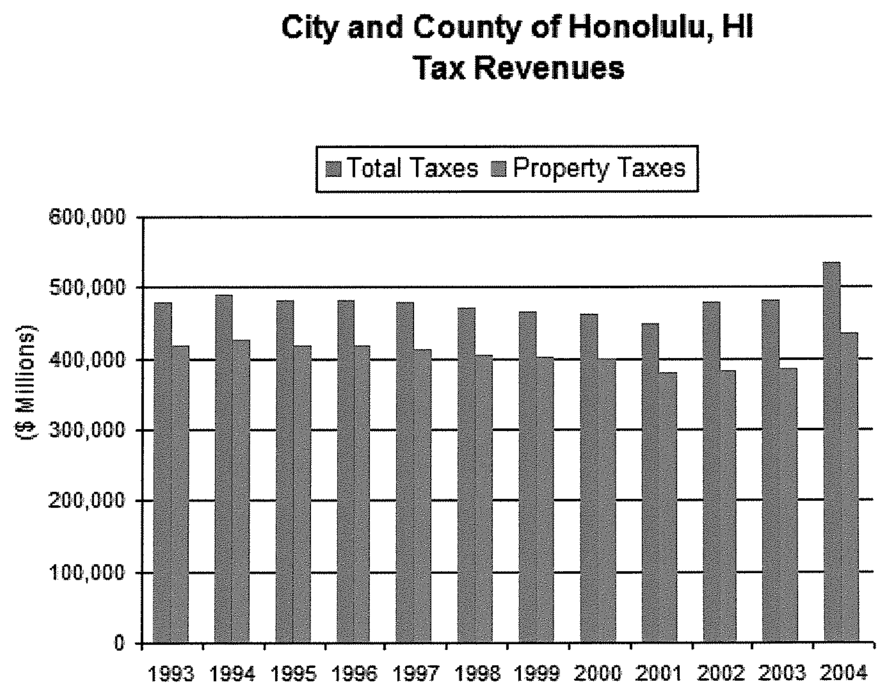


Finances

Property taxes are the city's primary discretionary revenue source, accounting for 70% of total general fund revenues. As a result, city revenues experienced significant pressure during the 1990s but have rebounded strongly. During the period of property tax declines, the city was able to cut expenditures, but also maintain lower-than-average fund balances. The average property tax rate was increased in 2004 after several years of reductions and was maintained at the 2004 level for the 2005 budget. The new city administration, elected in November 2004, has stated its intent to maintain property tax rates in order to support current service levels while paying close attention to the cost versus benefit of some more discretionary government expenditures. Property taxes in Honolulu and in Hawaii in general are currently among the lowest in the nation, as is the state's 4% sales tax. The city does not collect a sales tax but is distributed a portion of the state-collected transient occupancy tax (TOT), another major revenue source. Property tax delinquencies are currently at record lows.

The city maintains a 'rainy day' fund of $5 million that the current mayoral administration plans to build-up further through one-time sales of under-utilized city land and other assets, as appropriate. The city general fund has delivered cumulative surpluses totaling $20.8 million after transfers from fiscals 2002 through 2004, though it reported a $10.5 million deficit in fiscal 2004 due to a budgeted use of a portion of the existing unreserved fund balance. In fiscal 2005 (unaudited), staff anticipated a surplus of $14.8 million brought on, primarily, by mid-year cuts in certain budgeted costs and strong revenue growth. In practice, the city budgets the unreserved fund balance for use during the following fiscal year but does not expend the entirety of those appropriations. Tighter control over unreserved fund balances could be a relative credit strength as current staff continues to institutionalize additional formalized financial controls. Such controls could include the partitioning of reserves beyond the $5 million 'rainy day' fund, not to be appropriated for operating expenditures unless required due to economic or financial uncertainty.

Chart 2



Debt

In the late 1990s, the city restructured some of its debt profile to extend maturities and reduce some annual debt service carrying costs. The current amortization schedule achieves 59% payout of principal over the next 10 years. Upon taking office, the new city administration eliminated approximately $60 million in anticipated capital expenditures during fiscal 2005 deemed less essential than other core needs, such as road improvements. Additionally, fees and user charges have been increased substantially for the city's wastewater fund. This ensures that the wastewater enterprise will continue to be self-supporting both for operations and for additional debt, which is anticipated in order to upgrade the treatment facility to meet current environmental requirements.